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No 52

In the Supreme Court of the United States

OCTOBER TERM, 1931

HUBERT DALTON AND FLORENCE W. DALTON,
PETITIONERS

v.

FRANK C. BOWERS, AS EXECUTOR OF THE LAST WILL AND TESTAMENT OF FRANK K. BOWERS, AS COLLECTOR OF INTERNAL REVENUE OF THE UNITED STATES, FOR THE SECOND DISTRICT OF NEW YORK

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE RESPONDENT

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In the Supreme Court of the United States

OCTOBER TERM, 1931

No. 911

HUBERT DALTON AND FLORENCE W. DALTON, PETITIONERS

v.

FRANK C. BOWERS, AS EXECUTOR OF THE LAST WILL and Testament of Frank K. Bowers, as Collector of Internal Revenue of the United States, for the Second District of New York

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE RESPONDENT

We do not oppose the instant petition.

OPINIONS BELOW

The opinion of the United States District Court for the Southern District of New York (R. 86–91) is unreported. The opinion of the Circuit Court of Appeals (R. 189–193) is reported in 56 F. (2d) 16.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered February 23, 1932. (R. 194.) Petition for rehearing was denied March 14, 1932. (R. 203.) Petition for a writ of certiorari was filed May 2, 1932. While petitioners erroneously refer to Section 347 of the Judicial Code, the jurisdiction of this Court is presumably invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether under the circumstances of this case a loss sustained by petitioner Hubert K. Dalton in 1924, when his stock in the Dalton Manufacturing Company became worthless, was a loss "attributable to the operation of a trade or business regularly carried on by the taxpayer" within the meaning of Section 260 (a) (1) of the Revenue Act of 1924.

STATUTE AND REGULATIONS INVOLVED

The applicable statute and regulations are contained in the Appendix, *infra*, pp. 11–13.

STATEMENT

The District Court directed a verdict in favor of petitioners (R. 86–91) upon evidence which may be summarized as follows:

In 1917 (R. 46) petitioner Hubert K. Dalton, an inventor, designer, and engineer (R. 23, 32), and

the owner of certain patents upon his inventions (R. 28, 34, 58, 67, 75, 98), organized the Dalton Manufacturing Corporation under the laws of the State of New York (R. 26), and acquired all of the capital stock of the corporation at a cost of $395,000 (R. 26, 43, 54). He became president and treasurer and a director (R. 26, 48), and assumed control of the corporation (R. 48). He assigned some of his patents to the corporation (R. 29, 48, 58–59, 75, 98), and the corporation took over some of the assets of the Dalton Machine Company upon dissolution of that company in 1917 (R. 46, 49). In organizing the Dalton Manufacturing Corporation it was Dalton's purpose to have the corporation take over, develop, manufacture, and sell the articles invented by him (R. 49, 55–56), with a view to making his patented articles well known to the public and the corporate stock held by him more valuable (R. 33).

During the years 1917 to 1924, inclusive, Dalton was in active charge of the business and affairs of the Dalton Manufacturing Corporation.[1] (R. 48, 51.) He derived some income from other investments owned by himself and his wife. (R. 47.) Although the Dalton Manufacturing Corporation credited Dalton with a salary for the years 1917 to 1922, inclusive, he withdrew no money from the corporation (R. 43), and the corporation at no time made a profit (R. 47).

[1] Dalton spent from eight to ten hours a day at the office of the company during 1923 and five or six hours a day at the office of the company during 1924. (R. 51.)

During the years 1917 to 1923, inclusive, Dalton Manufacturing Corporation manufactured and sold Dalton lathes and other articles covered by Dalton's inventions (R. 27, 50), and also purchased and sold dogs, chocks, and collets to be used in connection with the Dalton lathes (R. 57), but the latter amounted to less than 1 per cent of the corporation's business. (R. 27, 57.)

Between 1917 and 1922, inclusive, Dalton loaned to Dalton Manufacturing Corporation $436,179.30 (R. 41–42), no part of which was ever paid (R. 57). During 1923 and 1924 he advanced an additional $72,569.83. (R. 38.)

In 1923 the corporation ceased active business operations and took steps to wind up its business. (R. 130.) At the close of 1923 its liabilities exceeded its assets by $176,462.01. (R. 131.)

In a joint return for 1923 Dalton and his wife claimed a deduction of $157,035.50 as a bad debt owing Dalton by the Dalton Manufacturing Corporation. (R. 129–130.) The assets of the corporation were disposed of in 1924 (R. 71, 74, 77) at a price which was less than the corporate liabilities (R. 41, 78–79). The corporation was formally dissolved in 1925. (R. 41, 46.)

In a joint income-tax return for the year 1925 Dalton and his wife claimed a deduction of $395,000, representing the cost of the Dalton Manufacturing Corporation stock. (R. 6, 7, 101, 102.) The Com-

missioner of Internal Revenue disallowed the deduction for the year 1925 (R. 7, 14), but held that the loss was sustained in 1924 and adjusted Dalton's taxes for that year accordingly (R. 10). He determined a deficiency for the year 1925 in the sum of $56,841.32 (R. 11, 20), which was paid under protest (R. 12, 15).

Suit was instituted in the District Court for the Southern District of New York (R. 4) to recover on one of two alternative causes of action (R. 22). The first cause of action (R. 4–9) was based upon the claim that the loss was sustained in 1925 and that, therefore, the Commissioner's determination of the deficiency for that year was erroneous. The second cause of action (R. 9–13) was based upon the theory that if the loss was sustained in 1924 petitioners had a net loss for that year of $374,078.98 which they were entitled to carry forward and deduct from their 1925 income of $291,702.31 as determined by the Commissioner, thus entitling them to a return of the $56,841.32 paid under protest as above stated. By stipulation the case was tried to a jury of one (R. 21–22), each side moving for a directed verdict at the close of the trial (R. 85). The District Court granted petitioners' motion for a directed verdict and in its opinion (R. 86–91) held that even though the loss was sustained in 1924, as determined by the Commissioner, it was nevertheless "incurred in a trade or business regularly carried on by the taxpayer in 1924" (R. 89), and

thus could, in part, be carried forward under the provisions of Section 206 (b) of the Revenue Act of 1924 (*infra*, p. 11), and accordingly entered judgment for the petitioners (R. 18–20).

The Collector appealed to the Circuit Court of Appeals for the Second Circuit (R. 181), where, reversing the judgment of the District Court it was held that the loss was sustained in 1924 (R. 193); that the Dalton Manufacturing Corporation was a legal entity, separate and distinct from Dalton, its stockholder, and that inasmuch as Dalton chose to do business through the corporation his loss was a capital loss and "did not occur in the operation of the trade or business regularly carried on by" him (R. 191).

Petitioners seek to have this Court review the decision of the court below, holding that the loss of $395,000 was not sustained in the operation of a trade or business regularly carried on by petitioner Hubert K. Dalton.

DISCUSSION

While the decision of the Circuit Court of Appeals is in accordance with well-established principles of law (*Goldberg* v. *Commissioner* (App. D. C.), 36 F. (3d) 551; *Hughes* v. *Commissioner* (C. C. A. 10th), 38 F. (2d) 755; *McCoach* v. *Minehill & Schuylkill Haven Railroad Co.*, 228 U. S. 295, 306), it nevertheless seems to be in conflict with the decision of the Circuit Court of Appeals for the Eighth Circuit in *Washburn* v. *Commissioner*, 51

F. (2d) 949, and with that of the Court of Appeals of the District of Columbia in *R. P. Clark* v. *Burnet*, No. 5386, decided April 11, 1932, not yet officially reported but to be found in Prentice-Hall Fed. Tax Service (1932), Vol. 1, p. 1252.

In *Washburn* v. *Commissioner, supra,* Washburn devoted his entire time to supervising the business of several corporations, including four lumber companies in which he was heavily interested. In order to facilitate the operations of one of the lumber companies he organized a railroad company, became its principal stockholder and managed its affairs. In 1922 he sold his stock in the railroad company at a loss, and the court held that the railroad company was not a separate and distinct enterprise but that it was organized and the road constructed as an aid to Washburn's timber-holding companies; that it was a part of the general enterprise; and that "It was merely the alter ego of petitioner." (P. 953.) It concluded (p. 955) that the loss sustained by Washburn upon the sale of his railroad company stock in 1922 resulted from the operation of a "trade or business regularly carried on by" the taxpayer within the meaning of Section 204 (a) of the Revenue Act of 1921 and reversed a contrary decision of the Board of Tax Appeals. While the court below thought that the *Washburn* case was "perhaps" distinguishable (R. 193) it seems reasonably clear that there is no such fundamental difference in the facts of the two cases as to justify a different result if the same rule were applied to both.

In *R. P. Clark* v. *Burnet, supra,* Clark held a majority of the stock and was the acting head of a corporation engaged in the dredging business. He was also a member of three different partnerships, two of which were engaged in the dredging business and one in river and harbor works and jetty building. The work of the partnerships was closely allied with that of the corporation and Clark took an active advisory interest in the partnership activities. The corporation experienced financial difficulties in 1921 and in order to protect his investment in the company Clark at various times became endorser upon the company's notes. As a result of such endorsements he was forced to pay the sum of $68,000 for the company in 1921. During that year he also sustained a loss of $9,500 on the sale of some of the company's stock. Those losses when added to his other deductions exceeded his gross income for 1921. In 1922, being desirous of having someone of financial strength associated with him in the corporation, Clark sold 1,000 shares of corporate stock which had cost him $100,000 for $7,500. In his return for 1922 he was allowed a deduction of the resultant loss of $92,500. However, the $92,500 when added to other deductions allowed by law for the year 1922 exceeded his gross income. Clark claimed the right to carry the unabsorbed losses of 1921 and 1922 forward to the year 1923 as a "net loss." The Board of Tax Appeals held that the loss was sustained in a capital transaction and

not in the operation of a trade or business. The Court of Appeals of the District of Columbia held (p. 1253) that Clark "was engaged in regularly carrying on the business of dredging, operated by a corporation of which appellant was principal owner and active directing head, and to which he devoted all of his time and energies." It accordingly reversed the decision of the Board of Tax Appeals and held that the loss sustained by Clark in the purchase and sale of the corporate stock resulted from the operation of a trade or business regularly carried on by Clark, within the meaning of Section 204 of the Revenue Act of 1921.

It will be observed that the court disregarded the corporate fiction and held that Clark was engaged in the business carried on by the corporation. If the principle of that case had been followed in the instant case a different result would doubtless have been reached.

There are many cases now pending in the courts, before the Board of Tax Appeals, and before the Commissioner of Internal Revenue involving facts substantially similar to those in the instant case and thus raising the question whether losses incurred as a creditor or a stockholder of a corporation by a taxpayer who is actively engaged in the management of the incorporated business enterprise are deductible "net losses" within the meaning of the applicable Revenue Acts. It is therefore important to the Government and taxpayers generally that the law should be settled. The facts in the

the Commissioner with the approval of the Secretary.

* * * * *

(U. S. C., Title 26, Sec. 937.)

Treasury Regulations 65, Relating to the Income Tax Under the Revenue Act of 1924

ART. 1621. *Net losses, definition, and computation.*—The term "net loss" as used in the statute applies to a net loss during the taxable year in a trade or business regularly carried on by the taxpayer. Included therein are losses from the sale or other disposition of real estate, machinery, and other capital assets used in the conduct of such trade or business. (See article 1654 with reference to the deduction of capital net losses.) In order to be entitled to claim an allowance for a "net loss" the taxpayer must have suffered an actual net loss in a trade or business during the taxable year. The amount properly allowed may be neither the loss reflected by the return filed for the purpose of the income tax nor the net loss shown by the taxpayer's profit and loss account, but is to be computed according to the statute, as follows:

(1) In the case of an individual it is the amount by which the deductions allowed under section 214, excluding:

(*a*) the amount by which the deductions otherwise allowed by law but not attributable to the operation of a trade or business regularly carried on by the taxpayer exceed the amount of gross income not derived from such trade or business;

(*b*) the amount by which the deductions for capital losses otherwise allowed by law exceed the capital gains; and

(*c*) the amount by which the deduction for depletion exceeds the amount which would be allowable if computed without reference to discovery value,

exceeds the sum of the following:

(*a*) the gross income of the taxpayer for the taxable year as computed under section 213; and

(*b*) the amount by which the interest received free from taxation under Title II of this Act exceeds the amount of interest paid or accrued which is not allowed as a deduction by section 214 (a) (2);

* * * * *

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